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EX PARTE

December 1, 1992

Ms. Donna R. Searcy
Secretary
Federal Communications Commission
1919 M Street, N.W., Room 222
Stop Code 1170
Washington, D.C. 20554

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RE: CC Docket 92-101: Employers' Accounting For Post Retirement Benefits
Other Than Pensions

Dear Ms. Searcy:

The attached material is submitted in response to questions asked in prior meetings pertaining to the above referenced proceeding. In accordance with the Commission's ex parte rules, please include a copy of this letter and the attachments in the record in this proceeding.

Acknowledgment and date of receipt of this submission are requested. A duplicate letter is attached for this purpose.

If you have any questions, please let me know.

Sincerely,



Attachments

Copy with Attachments:
Kathleen Abernathy
Pete Belvin
Mary Brown
Madelon Kuchera
Kathleen Levitz
Linda Oliver
Charla Rath
Cheryl Tritt
Greg Vogt

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Summary

A common concern running through recent meetings with Commissioners' staff members is whether OPEBs is a "real" cost and whether USW's filing represents the beginning of an endless parade of exogenous filings under the Commission's price cap regulations. In response to these concerns, USW submits that the Commission's price cap rules intentionally left open the door for exogenous treatment of OPEB costs. In addition, the Commission has a history of rulings on exogenous cost adjustments which are consistent with USW's instant filing.

The attached analysis shows:

1. The Commission consciously made a decision in the original price cap orders to defer resolving the exogenous treatment of OPEB until now. This is not a new issue and should be resolved using the same criteria used in the original price cap orders.
2. The Commission established the criteria for exogenous determination of the OPEB accounting change.
 - a. The GAAP change is outside the control of the carrier.
 - b. Exogenous cost treatment will not result in double counting within the context of the PCI.

U S WEST's tariff filing has satisfied both of these criteria.
3. OPEBs should not be treated any differently than the exogenous costs approved in the original price cap order.
 - a. Just as reserve deficiency amortization represented "costs which would have been assigned to previous years" so do OPEBs represent costs which should have been assigned to previous years.
 - b. Excess deferred taxes are non-cash expenses that are required to be trued-up. Constantly adjusting this accounting cost is no different than OPEBs.
 - c. Inside wire amortization is treated as exogenous because it will ultimately be eliminated. OPEBs should increase price caps during the amortization period because they represent unrecorded cost under rate of return regulation.
 - d. When the Commission required separations changes (which are accounting changes) to be treated as exogenous it noted that changes in accounting rules must be considered as changes that are beyond the LEC's ultimate control.
4. In denying exogenous treatment for depreciation expense the focus was on carrier capital investment decisions. The Commission concluded that existing depreciation rates were adequate based on its previous catch-up through reserve deficiency amortization. No such catch up has occurred for OPEBs.
5. U S WEST went into price caps with a \$2.5 billion unrecognized liability carried over from rate of return regulation.

Although OPEBs is indeed unique, it was by no means unforeseen. The LECs and the Commission knew of the changing accounting rules but chose to defer addressing the impact on the price cap regulations until now. Appropriate items for exogenous treatment will continue to be brought to the Commission's attention by interested parties. Fairness and the regulatory framework under which the Commission operates dictate that the Commission consistently apply the same criteria and rationale to equivalent situations in determining what is exogenous. OPEBs is clearly similar to the accounting changes representing real costs which have been treated as exogenous in the past.

Exogenous Cost Treatment - OPEBs

In the 4/17/91 Order on Reconsideration in Docket 87-313 the Commission determined how it would resolve the issue of Other Post-Employment Benefits (OPEB), primarily medical benefits to retirees. In paragraph 59 the Commission reiterated its LEC Price Cap Order conclusion that:

"... no carrier could treat GAAP changes as exogenous until we approved the change, and that exogenous treatment would not be granted until FASB had actually approved a change in GAAP, and the change became effective."

In delaying resolving the OPEB issue until a final order was issued by the FASB the Commission stated the following in paragraphs 62:

"Our decision not to consider exogenous treatment of GAAP changes, including OPEB expenses, until the GAAP change becomes effective is one grounded in the orderly administration of our price cap system. The requirement ensures that we will not be called upon to render decisions prior to the time FASB has made a final ruling.⁶⁵ We believe such a requirement will be helpful to our administration of price cap regulation. We believe declining to decide this OPEB issue until it becomes ripe will result in fairer treatment of the LECs. Under this decision, carriers that elected to wait until the GAAP change becomes effective before expending funds for OPEB are not necessarily foreclosed from recovering these costs. Instead, we will consider requests for exogenous treatment at that time. On the other hand, removal now of already accrued OPEB expenses from initial price cap rates would not only redefine "reasonable" after the fact, but it would also foreclose carriers from any recovery of expenditures already made." (Emphasis added)

It should not be a surprise to anyone that U S WEST is now asking for exogenous cost treatment for the OPEB costs associated with adopting the new accounting standard SFAS #106. U S WEST's request does not represent the beginning of many attempts to undermine the price cap plan with "new" requests for exogenous treatment. The LEC's were prevented from having this resolved at the time other exogenous cost issues were resolved going into price caps because the issue was "not ripe"! The Commission itself deferred the decision on this issue. The issue is now "ripe" and U S WEST is requesting that this cost be given the same treatment as other accounting costs that were decided going into price caps.

The Commission additionally addressed the issue of what the LEC's needed to show to receive exogenous treatment for GAAP changes in paragraph 63:

"Further, the test of whether to grant exogenous treatment of GAAP changes is not restricted to whether the change is outside the control of the carrier, as GTOC suggests.⁶⁷ As we discussed in the AT&T Price Cap Reconsideration Order, the determination of whether a particular GAAP change is exogenous includes an analysis of whether the cost change will be reflected in the inflation variable of the PCI.⁶⁸ If a GAAP change is universal enough to be reflected in

the inflation measure, exogenous cost treatment would result in double counting within the context of the PCI.⁶⁹

U S WEST presented the Godwins study to show that less than 1% of its OPEB costs will be included in GNP-PI. The Godwins study included sensitivity analyses using widely different assumptions that show that under any reasonable scenario GNP-PI will reflect no more than three percent of the costs of OPEBs. Moreover, GNP-PI is already reduced by the productivity factor in the price cap formula making recovery through GNP-PI even less likely.

The question of why OPEBs is beyond the control of U S WEST is answered by SFAS 106. After 12 years of deliberations, the Financial Accounting Standards Board's conclusion was clear -- pay-as-you-go accounting understates the true cost of labor. The FASB concluded these costs should be charged to the period in which the benefits were earned. In other words U S WEST's costs related to OPEBs have been understated ever since retirees have been given the benefit. This understatement of cost occurred under the Commission's rate of return ratemaking. In allowing companies to adopt SFAS 106 and issuing RAO letter 20 the Commission has recognized that the new accounting is preferred. The Commission has also recognized accounting costs for ratemaking purposes in its previous decisions on deferred taxes and pension costs. Clearly, the recovery of these costs are beyond the control of U S WEST.

Past Precedents

U S WEST's request is made under the Part 32 change provision of the Commission's exogenous rules and is no different from the exogenous treatment of other accounting costs in the original price cap orders. In four analogous instances where accounting changes were unrelated to business decisions under the control of the carrier, the Commission treated the costs as real and exogenous. In 3 of the 4 situations, the decisions resulted in substantial decreases to U S WEST's rates. The effect of the fourth should raise rates at some point in the future. The Commission's rationale must apply equally to similar situations whether or not the change results in increases or decreases to the PCI.

First, the Commission was clearly trying to adjust for an accounting cost when it ordered the LEC's to treat as exogenous the expiration of the reserve deficiency amortizations (RDA). In paragraph 292 of the Order on Reconsideration in Docket 87-313 the Commission stated:

"...The need to amortize depreciation reserve deficiencies was created, not by past decisions of this Commission regarding what plant lives should be, but by past methods of calculating depreciation expense. Formerly, we used methods which caused reserve imbalances to develop when carriers accelerated the retirement of plant.⁶⁰² Our present methods assure that, on a going-forward basis, this problem will not recur. The amortizations currently in effect are part of the transition from the old to the new methods. They represent depreciation expenses that would have been included in rates over many past years if we had been using our current methods all along. In contrast to the significant role

of the carrier in determining its current depreciation expense levels, there is nothing the carrier can do which will have any impact on the progress and expiration of these amortization. No perverse incentives' are created by requiring exogenous cost treatment of these amortization. On the other hand, it would be unfair to ratepayers who are now bearing the cost of the amortization program if rates were not adjusted downward at the end of the program..." (Emphasis added)

Additionally, in its Further Notice of Proposed Rulemaking in Docket 87-313 the Commission stated in paragraph 418:

"Unlike the expenses resulting from prescribed depreciation rates, amortization costs associated with eliminating the LEC's depreciation reserve imbalances are not related to productivity. Rather, they are the result of this Commission's policies and decisions concerning the rate at which investment is depreciated and the mechanisms by which error in service lives and salvage values can be corrected. The expenses that are being recovered through the amortization are costs which, with more accurate estimates, would have been assigned to previous years.⁸⁶³..." (Emphasis added)

Just as RDA represented "costs which would have been assigned to previous years" so do OPEBs represent costs which should have been assigned to previous years. As U S WEST has demonstrated in its OPEB filings and the Commission has agreed through its adoption of SFAS #106, previous years costs under rate of return regulation were understated. U S WEST is merely asking the Commission to rectify this understatement by allowing an exogenous increase which amortizes the federal portion of the \$2.5 billion understatement of prior costs that should have been recovered under rate of return regulation.

Another area where the Commission addressed accounting costs in its original price cap orders was tax law changes. Although the Commission ruled in general that tax law changes were endogenous because it presumed these changes would be included in GNP-PI, it also concluded in paragraph 406 of the Further Notice of Proposed Rulemaking in Docket 87-313 that:

"We also tentatively find that price caps should be adjusted to flow through to ratepayers any incremental changes in the flow back of excess deferred taxes from the amounts currently flowing back to ratepayers in 1988 rates...To the extent that current rates already reflect a flow back adjustment, there is no need to adjust price cap levels further to reflect the flow back unless the rate at which excess deferred taxes are flowed back changes. A decrease or increase in the rate of the flow back should trigger an adjustment to price caps."

Once again, a change in the flow back of excess deferred taxes is an accounting change. Excess deferred taxes represents a return to ratepayers of taxes collected through rates in periods prior to price cap regulation. There is no cash being transferred back and forth between U S WEST and the US government. Under rate of return regulation prices were reduced to return to ratepayers taxes previously collected that were no longer needed to pay future tax liabilities related to profits

generated in previous years. When the amortization of these excess deferred taxes is complete U S WEST's prices will be higher, since these changes are exogenous, and prices will reflect U S WEST's true tax costs when price cap regulation began.

Again, the Commission is treating as exogenous an accounting cost change that was in place to remedy cost distortions in the years prior to price cap regulation. U S WEST is asking the Commission to recognize the same cost distortion that occurred under rate of return regulation for retiree medical benefits.

Third, the Commission applied consistent treatment to the amortization of inside wire discussed at paragraphs 78 and 79 of the Order on reconsideration in Docket 87-313.

"...The Commission reasoned that, although the LECs were entitled to recover the amortized amounts from ratepayers, upon expiration of the inside wire amortizations, the costs should be removed from rates in recognition of the newly-deregulated status of inside wire..."

"...Under rate of return regulation, amortization of inside wire would continue to decrease depreciation expense, thereby lowering the rate base, until the amortization was complete. That same effect can be obtained by treating inside wire amortizations as an exogenous cost under price caps. We believe that classifying inside wire amortizations as exogenous treats both LECs and ratepayers fairly -- the LECs because they are allowed to recoup their capitalized costs of inside wire, and ratepayers because our decision to change regulatory structures should not interfere with the promise of lower carrier costs upon the completion of the amortization." (Emphasis added.)

Here the Commission again reviewed an accounting amortization that was in place under rate of return regulation and determined that prices should be reduced as these costs expire in fairness to ratepayers. Since inside wire has been deregulated, the amortization will eventually end so prices should be reduced to a level that reflected the LECs ongoing cost. In the case of OPEBs, U S WEST is asking that the prices going into price caps reflect our ongoing cost of doing business. This ongoing cost includes 17- 20-year amortization period to catch up the federal portion of the \$2.5 billion of unrecognized cost under the Commission's rate of return regulation.

Fourth, the Commission has also determined that separations changes are exogenous. Once again separations is an accounting practice that divides both cash and non-cash costs between state and federal jurisdictions. Paragraph 408 of the Further Notice of Proposed Rulemaking in Docket 87-313 stated:

"...changes in jurisdictional separations are decisions made by regulators over which carriers exercise no ultimate control...Moreover, regulators must be able to alter separations procedures in response to both changes in technology and changes in other regulations, such as accounting rules..."

Clearly, the Commission recognized in its original price cap orders that accounting rules changes can be beyond the LEC's control.

In situations where the Commission denied exogenous treatment for expense changes the Commission determined that the costs were related to carrier business decisions. For example, in denying exogenous treatment for changes in depreciation rates the Commission focused on the carrier's capital investment decisions. In paragraph 415 of the Further Notice of Proposed Rulemaking in Docket 87-313 the Commission stated:

"...In fact, the amount of depreciation expense on a carrier's books, and fluctuations in that amount, are the result of some of the most important and thoroughly considered management decisions that a carrier makes -- i.e. its capital investment decisions.⁸⁵⁹...In large measure, how effective a carrier is in these decisions determines how productive and how efficient its operation will be. As a result, we tentatively conclude that it would be incorrect to categorize depreciation expense as an exogenous factor that could translate increased costs into higher price caps. To do so would be to establish an artificial distinction between capital costs (investment) and operational costs (depreciation expense related to that investment)."

In reaching its conclusion the Commission tied depreciation expense to capital investment decisions. This conclusion would apply also to OPEBs if the level of costs charged in prior years reflected the true cost of providing OPEBs. In its depreciation conclusion the Commission stated that, with the exception of reserve deficiency amortizations, the level of depreciation expense was proper. In the case of OPEBs, it cannot be argued that the cost included in rates going into price caps reflected the proper level of expense. The cumulative understatement of OPEBs was \$2.5 billion for U S WEST.

CONCLUSION:

Although OPEBs is indeed unique, it was by no means unforeseen. The LECs and the Commission knew of the changing accounting rules but chose to defer addressing the impact on the price cap regulations until now. Appropriate items for potential exogenous treatment will continue to be brought to the Commission's attention by interested parties. Fairness and the regulatory framework under which the Commission operates dictate that the Commission consistently apply the same criteria and rationale to equivalent situations in determining what is exogenous. OPEBs is clearly similar to the accounting changes representing real costs which have been treated as exogenous in the past.